High Pointe Capital Management, LLC
One North LaSalle, Suite 2001
Chicago, Illinois 60602
312.726.2500
312.726.6100 fax
www.highpointecapital.com

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DATE: April 19, 2013
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

Lucky 7

When I was young, I paid $25 for the rights to operate the Lucky 7 game at a local carnival. The way the game worked was that a player had to bet on the simultaneous roll of two dice. He could bet that the sum of the two dice would be Under 7, Exactly 7, or Over 7. If he predicted correctly, your payoff was $2 for a bet of $1 for Under 7 and Over 7, and $3 for a bet of $1 for Exactly 7.

One of my friends argued he had a strategy to play the game such that he would always come out a winner at the end. He would start by betting $1 on Under 7. If he won in the first round, he would stop playing. If he lost the first round, he would bet again on Under 7, but double his bet to $2. If he won the second round, he would have $4 in winnings compared to $3 in money wagered, and he would stop playing. If he lost in Round 2, he would bet again on Under 7, and double his bet from $2 in the second round to $4 in the third round. This process will continue until Under 7 appeared on the table, and as soon as it did, the player would have covered all costs and ended up with a gain of $1. And, the laws of statistics do imply that Under 7 has to appear sooner or later.

Sounds interesting and believable? Perhaps, but don't get sucked into this logic because it involves an assumption that you have unlimited money to wager. If Under 7 does not appear 10 times in a row, you would lose $1,023 and need $1,024 to bet in the next round. So, the only players who should use this strategy are those that have unlimited amounts of money.

There are three people in this world who are using this strategy today because they have a license to print money. Their names are Bernanke, Draghi and Kuroda. They first printed money to generate economic growth. When that did not happen, they began printing more money and kept interest rates low to entice investors to buy stocks and other risky assets. A few investors are succumbing to the persuasion. The low interest rates on bank accounts and the regret of having missed the rally have caught up with some retail investors who invested $65 billion in stocks last quarter after being in retrenchment most of the last five years.[1]

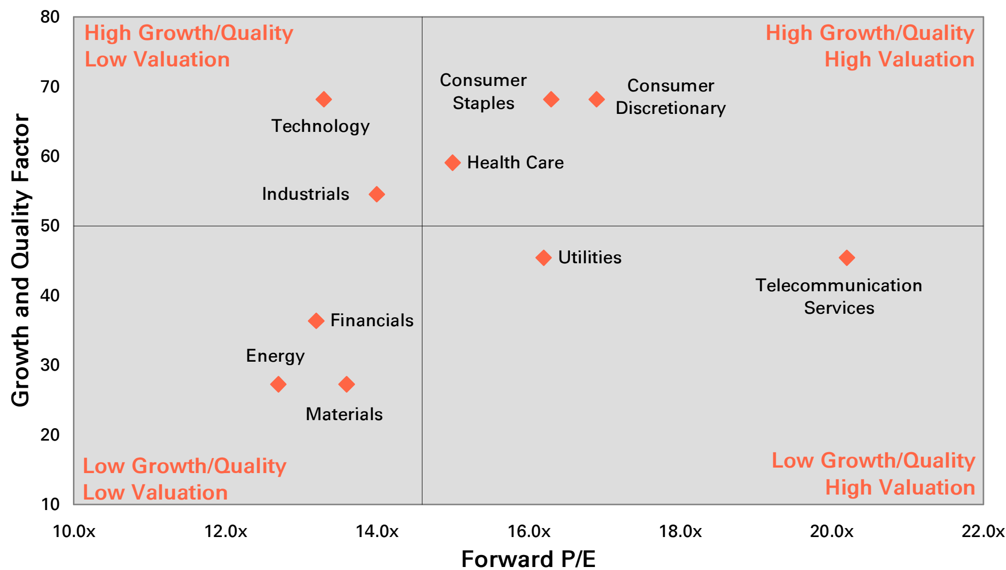
There are two ways to interpret this reversal by retail investors. One is to conclude that investors have decided to drink the Kool-Aid being offered by the Fed (remember Rev. Jim Jones?) and that

[1] Investment Company Institute (2013, April 17) based on cash inflows into equity mutual funds. Retrieved April 17, 2013, from http://www.ici.org/research/stats/flows.

their re-engagement will sustain the stock market's momentum. The other interpretation is that the reversal is nothing more than a blip and that retail investors should not be counted on to sustain the stock market rally. In our opinion, the second interpretation is correct. Investors' financial condition is hardly strong, prospects of strong economic growth are bleak and memories of the financial crises have not faded.

There is perhaps one other factor at work too. Investors, in aggregate, are smart enough to realize that there is something wrong here. The mere fact that central bankers have to cajole investors to get in the stock market sends a cautionary signal. So, it is all very ironic. The Fed wants investors to feel confident, take risks, invest and help the economy grow. But, the Fed's involvement signals to investors that economic prospects are weak and that keeps them from being confident. Corporations, for sure, are not following the Fed's lead. Most companies have accumulated above average levels of cash on their balance sheets and they are keeping a lid on capital spending. So, the institutional crowd is keeping risk taking at a low level.

The Fed's interference is causing distortions but it is not eliminating good investment opportunities in the stock market. One just has to know where to look for such opportunities. We conducted a simple exercise to convey our thoughts about stock market opportunities. We ranked each of the sectors of the stock market on two variables - Earnings Growth Prospects and Company Quality. We then used simple algebra to convert our rankings to a score on a scale of 1 to 100.[2] We then plotted this growth and quality score against the valuation of each sector, as shown below.



Source: "US Equity Strategy", April 4, 2013, Adam Parker, Morgan Stanley and High Pointe

This vertical axis on the graph shows the combined growth and quality score of each sector. The higher the score, the better the sector is in terms of its quality and growth prospects. The horizontal axis shows how expensive each sector is in terms of price-to-earnings ratio. The data show that Telecommunications and Utilities are expensive despite having below-average growth and quality characteristics, whereas Technology is inexpensive despite having above-average characteristics.

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[2] Each sector is ranked on the basis of consensus Long-Term Growth estimate and Quality (measured by VIX Beta) from lowest to highest. The rank is then averaged to provide a single score which is converted to a scale of 1 to 100 by simple algebraic transformation.

While simplistic, this grid is nevertheless a useful way to think about where opportunities lie and how we are positioning our portfolios to match these opportunities.

High Pointe's viewpoint is partly in sync with the average investor and partly contrarian. We agree that it does not make sense to overweight speculative or highly leveraged sectors just because interest rates are low. However, we disagree with the average investor's assessment on Technology, Telecom and Utilities. We think the strong balance sheet of Technology companies makes them relatively safe and that combined with their low valuation makes them attractive investments. Conversely, we think that Telecom and Utilities have been bid up to an unsustainable level by investors who are chasing high dividend yield without paying sufficient attention to these companies' poor growth prospects. We believe focusing on valuation relative to growth and quality, and avoiding the hypnotic charm of a high dividend yield, is the right way to succeed in this market.

Before closing, here is a quick recap of my only day being a "casino owner" at the local carnival a long time ago. First, you should know that the House's cut on Lucky 7 is about 17% when someone bets on Under 7 or Over 7, and 50% when someone bets on Exactly 7. I had just recovered my $25 investment when the local cops showed up to shut down all games of luck at the carnival. Even though I did not make much money that day it was still a worthwhile day because I learned that the merits of a strategy can only be evaluated by analyzing hard data. An inherently flawed strategy cannot succeed just by throwing more money at the problem. If I am ever offered the opportunity to run the Lucky 7 table again, I would ask two questions. One, "do the cops have any objections," and secondly, "do I have the right to refuse Mr. Bernanke a seat at the table."